SUBJECT INDEX.

ARGUMENT—Summary of Argument— PAGE

POINT A. Whether the Central Bank was a holder or bearer of the checks depends on the decision as to whether or not its conduct constituted final or irrevocable payment. If it did not, then the Central Bank was a holder or bearer, with all the rights of the prior holder in due course..... 1

POINT B. Settlement of the Clearing House balance did not constitute final and irrevocable payment.... 4

POINT C. Failure of the Central Bank to notify the Clearing House in the one case and the First National Bank in the other, of non-payment within the time limit prescribed by the rules of the Clearing House, did not constitute final and irrevocable payment as to the Ashland Bank as it was not a member of the Clearing House and, therefore, in no way affected by its rules..... 8

POINT D. There was no duty owing from Central Bank to Ashland Bank under the Clearing House rules. Therefore, the only possible requirement was that of giving notice of non-payment of the checks as required by law. This was done. Central Bank was not required to give notice to all endorsers but only to those it intended to hold..... 14

Table of Cases Cited.

	PAGE
Columbia K. Trust Co. v. Miller, 215 N. Y. 191	5
Hentz v. National City Bank, 144 N. Y. 979	5, 6
Merchants National Bank v. National Bank of Commonwealth, 139 Mass. 518	8, 10
National Bank of Commerce v. Seattle, 109 Wash. 312, 187 Pac. 342	2
National Exchange Bank v. Ginn & Co., 114 Md. 181	8, 9, 15
Schneider v. Bank of Italy, 194 Pac. 102 (Cal.)	5, 11

Table of Statutes Cited.

Illinois Revised Statutes, 1933, Cahill, Chap. 98, Sec. 9, Sub-sec. 5	4
Illinois Revised Statutes, 1933, Cahill, Chap. 98, Sec. 58	4
Illinois Revised Statutes, 1933, Cahill, Chap. 98, Sec. 102	14
Illinois Revised Statutes, 1933, Cahill, Chap. 98, Sec. 190	4

Textbooks Cited.

Brady on Bank Checks (2nd Ed.), 502	4, 8, 10
Corpus Juris, Vol. 8, p. 643, Sec. 905	16
Michie on Banks and Banking, Vol. 5, p. 575	5
Michie on Banks and Banking, Vol. 8, p. 165	8, 10
Morse on Banks and Banking (6th Ed.), Vol. 1, p. 810	8
Ruling Case Law, Vol. 3, p. 1222, Sec. 444	15

IN THE

Supreme Court of the United States

OCTOBER TERM, A. D. 1934.

No. 600

HARRY E. HALLENBECK, Receiver of SOUTH ASHLAND NATIONAL BANK,

Petitioner,

vs.

W. F. LEIMERT, Receiver of CENTRAL MANUFACTURING DISTRICT BANK,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

BRIEF FOR RESPONDENT.

Point A.

Whether the Central Bank was a holder or bearer of the checks depends on the decision as to whether or not its conduct constituted final or irrevocable payment. If it did not, then the Central Bank was a holder or bearer, with all the rights of the prior holder in due course.

Under "Point A" in their brief, Counsel contend that the presentment of a check to the drawee for payment is

not a negotiation and the drawee does not become a holder, and cite certain authorities to support the contention.

We answer that this is the rule only where the drawee unconditionally pays or accepts the check. In such event it naturally follows that there is no negotiation of the check and the drawee cannot become a holder because the check has no further force.

This is all that is held by the authorities cited under this heading by Counsel. In each case cited unconditional payment was made.

In *National Bank of Commerce* v. *Seattle,* 109 Wash. 312, on page 322 (cited by Counsel), the Court states that the rule is clearly stated in *First National Bank* v. *Bank of Cottage Grove,* 59 Ore. 388, and quotes as follows:

> "When the defendant bank, which was a holder in due course presented these checks to the plaintiff bank, the drawee, *and they were honored, accepted and paid,* —(Italics ours)—the prior indorsers were thereby discharged from further liability. The checks when so paid were no longer checks within the meaning of the negotiable instrument law, but only cancelled vouchers; and the plaintiff was not a holder in due course."

Counsel quote from *National Bank of Commerce* v. *Seattle National Bank,* 109 Wash. 312; 187 Pac. 342 at 346, to a certain point and then stop. They quote as follows:

> "'Holder' refers to one who has taken the instrument as it passes along in the course of negotiation towards the drawee and not the latter."

They place a period here but such is not the case in the decision. There is a comma and the Court proceeds

> "who, upon the acceptance and payment of the instrument, thereby strips it of all negotiability and reduces it to a mere voucher or proof of payment."

Such was not the situation in the case at bar.

Here the checks come through the Clearing House and the balance was settled according to its rules. Under those rules the Central Bank had the right to send back such checks as it should elect not to pay, provided notice of non-payment was given within the prescribed time. At the time the settlement was made the checks were delivered to the Central Bank and it advanced value therefor. Between the time that such settlement was made and the checks delivered, to the time that was prescribed by the rules for giving notice of non-payment, what relation did Central Bank bear to the checks, if not that of holder or bearer? Certainly if the Central Bank had the right to return those checks, after examination and investigation, it cannot well be said that the checks were paid or accepted. They were, therefore, not reduced to "mere vouchers or proof of payment."

We contend, therefore, that the Central Bank under the circumstances was a holder in due course. But, if it be conceded that it was not a holder in due course, it seems certain that it was a holder or bearer, at least to the time that notice of non-payment was required by the Clearing House rules.

Four of the checks were endorsed by Ashland Bank to the Federal Reserve Bank, which, in turn, endorsed them payable to any bank or banker. The other check was endorsed by Ashland Bank payable to the First National Bank, which endorsed it in blank.

This made all the checks payable to bearer.

Section 9 of the Negotiable Instrument Act, Sub-section 5, provides that an instrument is payable to *bearer*

> "When although originally payable to order, it is endorsed in blank by the payee or a subsequent endorsee."

The Federal Reserve Bank and the First National Bank were holders in due course of the respective checks.

Section 58 of the Negotiable Instrument Act provides that:

> "In the hands of any holder other than a holder in due course, a negotiable instrument is subject to the same defenses as if it were non-negotiable. But the holder who derives his title through a holder in due course, and who is not himself a party to any fraud or duress or illegality affecting the instrument, has all the rights of such former holder in respect to all parties prior to such holder."

Section 190 of said Act defines a *Holder* as:

> "The payee or endorsee of a bill or note, who is in possession of it, or the bearer thereof."

Point B.

Settlement of the Clearing House balance did not constitute final and irrevocable payment.

The fact that the Central Bank gave its check in settlement of the Clearing House balance, and that four of the checks in question, were among those which went to make up this balance, does not constitute payment. After making such settlement, the Central Bank had the right to a reasonable opportunity to examine the checks and the accounts on which they were drawn, and dishonor the checks that were not supported by the account on which they were drawn.

The Circuit Court of Appeals properly held this to be so and that the check given by the Central Bank in settlement of the Clearing House balance did not constitute final payment.

Brady on Bank Checks (2nd Ed.) 502.

Schneider v. *Bank of Italy*, 194 Pac. 1021 (Cal.).
Columbia-K. Trust Co. v. *Miller*, 215 N. Y. 191.
Hentz v. *National City Bank*, 144 N. Y. 979.
5 Michie on Banks & Banking, 575.

In *Columbia-Knickerbocker Trust Company*, 215 N. Y. 191, in discussing the question of whether or not the settlement of a clearing house balance constituted payment of any particular check, the court said:

> "Doubtless, the adjustment of balances by the Clearing House constitutes a sort of tentative or provisional payment, but that adjustment occurs without an opportunity to the members to examine the items, verify signatures, compare the amounts with the drawers' accounts, and the like, and regardless of whether the checks are good. The constitution of the association contemplates that the members will directly adjust between themselves claims arising from the return of checks. It thus appears that the question of payment is not, and cannot be, ultimately decided until the bank upon which the check is drawn has had an opportunity at its banking house to examine the checks."

In the same decision the Court also said:

> "Concededly, the adjustment of the accounts at the Clearing House is, at most, tentative and provisional, and subject to an examination by each member of the checks drawn upon it."

In Brady on Bank Checks (2nd Ed.) 502, it is said:

> "The transaction whereby a check is delivered at the Clearing House to a representative of the bank on which it is drawn and the presenting bank receives money or credit for the amount does not in itself constitute a payment of the check."

In *Schneider* v. *Bank of Italy*, 194 Pac. 1021, (Supreme Court of Cal. 1920), two certain checks were drawn by Schneider against his account in the Bank of Italy. The

two checks were endorsed by the payee and delivered to the Wells Fargo Bank. The latter bank sent them to the clearing house where they were delivered in the course of the clearings to the clearing house representative of the Bank of Italy and in turn, for the purpose of clearing the accounts between the two banks, the Bank of Italy gave money or credit to the Wells Fargo Bank. The sole issue in the case was whether or not these two checks were paid by the Bank of Italy on that day, which was March 14, 1918. With reference to this question the court said:

> "The clearing house transaction on the morning of March 14th wherein the Wells Fargo Bank received the amount of two checks from the Bank of Italy in credit or otherwise, did not, in and of itself, constitute a payment of the checks."

In *Hentz* v. *National City Bank*, 144 N. Y. S. 979 (Supreme Court of N. Y. App. Div.):

> "Taking into consideration the rules of the clearing house, which, so far as affects the question here presented, are set forth in *Mt. Morris Bank* v. *Twenty-third Ward Bank*, 172 N. Y. 244, 64 N. E. 810, and *Citizens' Central National Bank* v. *New Amsterdam National Bank*, 128 App. Div. 554, 112 N. Y. Supp. 973, affirmed 198 N. Y. 520, 92 N. E. 1080, it at once becomes apparent, as it seems to me, that the conclusion reached by the court at Special Term is erroneous. A payment through the clearing house and a payment over the counters of a bank upon which a check is drawn are entirely different. The clearing house is simply a representative of all the banks who are members of it. Its purpose is to enable these banks to go to the clearing house each day and there present checks drawn on the presenting bank which have been sent in by some other member. The clearing house then balances the checks sent by a bank against those sent to it, and later in the day a bank either pays or receives the balance due to or owing by it; in other words, it is an adjustment of balances, solely for the convenience

of the banks who are members of the association. It is in no sense a payment binding upon the bank upon which it is drawn, so far as the payee named therein is concerned, since under one of the rules of the clearing house association a check or draft thus received may be returned to the bank from which it is received at any time that day before three o'clock in the afternoon.

The payment of a clearing house balance is not a payment of any particular check and does not become so until the time within which the check may be returned has expired. Daniel on Negotiable Instruments, par. 1622a; *Stuyvesant Bank* v. *National Mechanic's Banking Ass'n.*, 7 Lans. 197; *Merchants' National Bank* v. *Bank of the Commonwealth*, 139 Mass. 513, 2 N. E. 89."

The check given by Central Bank, in settlement of the Clearing House balance did not constitute payment and it had the right to dishonor the checks. It did so. Counsel, practically, concede this but claim that having elected to dishonor the checks, the Clearing House should have been notified by two thirty o'clock in the afternoon on the same day, in accordance with its rules; that, as the Central Bank did not give such notice, the payment became unconditional and irrevocable after two thirty o'clock in the afternoon.

Point C.

Failure of the Central Bank to notify the Clearing House in the one case, and the First National Bank, in the other, of non-payment within the time limit prescribed by the rules of the Clearing House, did not constitute final and irrevocable payment as to the Ashland Bank, as it was not a member of the Clearing House, and, therefore, in no way affected by its rules.

The rules of the Clearing House are binding upon and for the benefit of its members alone and non-members cannot claim the benefit thereof.

1 Morse on Banks and Banking, (6th Ed.) 810.

National Ex. Bank v. *Ginn & Co.*, 114 Md. 181.

Merchants Nat'l. Bank v. *National Bank of the Commonwealth*, 139 Mass. 518.

Brady on Bank Checks, (2nd Ed.) 503.

8 Michie on Bank & Banking, 165.

In 1 Morse on Banks and Banking, (6th Ed.), it is said:

"The By-laws, rules and usages are binding upon members of the association. No outside bank is under any degree of obligation to observe them. But, on the other hand, no outside bank can have any remedy against any member of the association for a breach of them. They are in the nature of a contract to which the outsider is no party. The duty of adhering to them runs from each of the members to each and all the rest, but to no other person or corporation; at least unless any special and peculiar course of dealing between any member and any outside individual has operated to place that member under an express and exceptional obligation to the outsider to adhere in all matters in which he is interested to the regulations of the clearing house. Generally, 'those who are not bound by such usages and have not contracted with reference to them, have no right to avail themselves

of them to create an obligation against those who are parties to their adoption and bound by them *inter sese* only."

In *National Exchange Bank of Baltimore* v. *Ginn & Company*, 114 Md. 181, a very similar situation to the one in the present case was presented. There, also, there was a failure on the part of the drawee bank to return a certain check within the time limited by the clearing house rules. The drawee bank in the case was a member of the Baltimore Clearing House. The payee of the check, however, was not a member and therefore stood in the same position as the Ashland Bank in this case. In discussing the effect of the drawee bank's failure to comply with the clearing house rules, the court said (p. 1027):

"As the suit is directly against the payee of the check, the situation is not affected by the rules of the clearing house through which it was presented and collected. One of these rules provides 'that errors in exchange and claims arising from the return by eleven o'clock a. m. directly between the banks, which are parties hereto, and not through the clearing house,' and that 'upon request made before eleven o'clock a. m. every bank shall extend until twelve o'clock the time for returning to it checks 'not good.' When the offer was made at about a quarter to twelve o'clock to return the check under consideration, it was refused upon the ground that it was made after 11 o'clock, and that there had been no request prior to that hour for an extension of time. It is well settled that such a regulation is binding only upon the members of the Clearing House Association. Its rules are designed exclusively for their convenience and protection as among themselves, and have no effect upon the rights or liabilities of other parties. 5 Cyc. 614; *Merchants' Nat. Bank* v. *Nat. Bank of Commonwealth*, 139 Mass. 518, 2 N. E. 89; *Overman* v. *Hoboken City Bank*, 30 N. J. Law, 61. The failure of the appellant to offer to return the check and to demand repayment within the

time prescribed by the rules of the clearing house would therefore not impair its claim against the payee for the restoration of the fund if its right of recovery should be found to be otherwise perfect."

In *Merchants National Bank* v. *National Bank of the Commonwealth*, 139 Mass. 518, it was said of the Boston Clearing House Association:

"To the regulations of this association the customers of the banks are not parties, and whatever effect is to be given to them as between the banks, their customers are not in a situation to claim the benefit of them, nor are they liable to be injuriously affected by them."

In Brady on Bank Checks, (2d Ed.) at page 503, it is said:

"While the rules enacted by the banks which comprise a clearing association are binding upon the members of the association they are not, as a general rule, permitted to have any effect upon the rights of outsiders, such as depositors and other customers of the banks. Clearing house rules are not binding on such parties, nor have they the right to claim any benefit under them, unless they contract with reference to the rules. And the rules are not finding upon member banks in their dealings with each other wherein the clearing house is not involved."

In Michie on Banks and Banking, at page 165, it is said:

"The rules of a clearing-house association are adopted solely for the purpose of facilitating exchanges among the banks, which are its members. They do not affect the rights and liabilities of banks and persons who are not members of the association or parties to its regulations.

* * * The regular customers of or depositors in banks, however, are not parties to the rules and regulations of a clearing house of which such banks are members, and are not, therefore, in a situation to claim the benefit of them, nor liable to be injuriously affected by them. And the rules of a clearing house as such do

not govern the rights of a drawer or payee of a check who are not members of the clearing house and do not contract with express reference to such rules."

It is to be observed in this respect that although the Ashland Bank, was, of course, a banking institution, so far as it is concerned in this transaction it was no more and no better than an ordinary individual depositor or customer of the Federal Reserve Bank. It was the payee of three of the checks which went through the Clearing House and was the endorsee of the fourth. The checks were its own property, and not merely cashed by it for Hodgkinson or anyone else. When it deposited these four checks in the Federal Reserve Bank for collection it was in no different and no better position than that of an ordinary citizen who might have walked into any loop bank which was a member of the Clearing House and deposited in his own account similar checks for collection. It was no more a member of the Clearing House than such a citizen and as an ordinary customer or depositor in a member bank, it is no more entitled to take advantage of the Clearing House rules than the individual depositor.

In *Schneider* v. *Bank of Italy, supra*:

"The rules of the Clearing House as such do not govern the rights of a drawee or payee of a check who are not members of the Clearing House, and do not contract with express references to such rules."

There is no evidence whatsoever in this case to show that there was any contract between the Central Bank and the Ashland Bank "with express reference" to the rules of the Chicago Clearing House. There is nothing in the case to take it out of the general rules expressed in the authorities here cited.

From the foregoing it will appear that the settlement of

the Clearing House balance did not constitute irrevocable and final payment. If we are correct in our conclusions, this is practically conceded by our opponents. But, they say, that if this is conceded, the payment became final when notice of non-payment was not given by two thirty o'clock in the afternoon in accordance with the rules of the Clearing House.

Our answer is that the rules of the Clearing House have nothing to do with the rights and obligations of Ashland Bank, because it was not a member. We submit that the authorities, quoted above, sustain this answer.

Then our opponents say (Under Point "A" of their brief) that:

> "it would seem to be a manifest absurdity to say that the obligation assumed by an indorser to reimburse subsequent holders if the drawee refuses to pay the check upon presentment, is an engagement by the indorser with the drawee himself, the very party on whom the check is an order to pay."

Of course, this would be true if the drawee paid or accepted. It would then be an absurdity to ask an indorser to reimburse. And that is what the cases, cited by Counsel, hold.

But that is not the situation here. The checks in question were only a part of a large number of checks presented by the Clearing House. The rules of the Clearing House provide in substance this: "We know that when these checks are presented to you, you will have no immediate opportunity to investigate. Nevertheless, our rule is that you must make settlement at the time the checks are presented. After that you may have the opportunity to investigate. If you find on such investigation that some of the checks should be dishonored—should not be paid, we grant you the right to dishonor and not pay. But we say, that so far

as the liability of any of our members is concerned, you must make your election by a certain time. If by that time you do not notify us that you have elected to refuse payment—to dishonor the checks—then, so far as our members are concerned, it will be considered that you have honored the checks; and, so far as they are concerned, this consideration will be binding on you and you will have no right to hold any of them, if you later find that payment or acceptance should not have been made.

Therefore, so far as the endorsers were concerned, who were members of the Clearing House, the notice of non-payment not having been given within the prescribed time, the settlement was final payment as to them.

But Ashland Bank was not a member of the Clearing House. However, it was the first endorser, the payee. There was no obligation on the Central Bank to give notice to subsequent endorsers unless it wanted to hold them. When notice is given to the last endorser, he may hold the prior one and so on to the first. Here Central Bank elected to hold the first endorser, Ashland Bank, the payee, and it was not a member of the Clearing House. This being so the Clearing House rules did not apply and notice was properly given within the time prescribed by law.

The situation is the same as if the Ashland Bank had presented the checks to the Central Bank for payment and it had given the money to the Ashland Bank on condition, only, that Central Bank would have the right to investigate the account and, then, if the account was found to be unsatisfactory, to return the checks within the time prescribed by law and get the money back from the Ashland Bank. It is the same as if the Central Bank said to the Ashland Bank, at the time the check was presented that it would turn over the money but only on condition that

Ashland Bank would return the money, if, on examination, Central Bank elected to return the checks within the time prescribed by law.

Under "Point E" of their brief, Counsel state that the Trial Court and the Court of Appeals, both held that the Clearing House transactions in the case of four checks, and the transaction with the First National Bank in the case of one check, did not constitute payment and that upon this premise, it necessarily follows that if payment was not made by the Central Bank to the Federal Reserve Bank, or to the First National Bank no money of the Central Bank passed from the Federal Reserve Bank or from the First National Bank to the Ashland Bank, etc.

This is purely a theoretical assumption.

The evidence shows without contradiction that the Federal Reserve Bank and the First National Bank got the money from the Central Bank and, in turn, gave the money to the Ashland Bank.

Point D.

There was no duty owing from Central Bank to Ashland Bank under the Clearing House rules. Therefore, the only possible requirement was that of giving notice of non-payment of the checks as required by law. This was done. Central Bank was not required to give notice to all endorsers but only to those it intended to hold.

Section 102 of the Negotiable Instrument Law, with respect to the giving of notice of dishonor, provides:

> "Where the person giving and the person to receive notice reside in the same place, notice must be given within the following times:
>
> 1. If given at the place of business of the person to receive notice, it must be given before the close of business hours on the day following."

The Central Bank complied with this requirement. It gave notice to the Ashland Bank, through James G. Hodgkinson, its vice-president, on Monday, April 25th, immediately upon discovering the fact that payment of the checks would create an overdraft in the Corporation's Account, and, long, before "the close of business hours on the day following"—in fact at nine thirty o'clock on the morning of April 26th—the actual checks were tendered back to the Ashland Bank and demand for reimbursement made.

In *National Exchange Bank of Baltimore* v. *Ginn & Co.*, 114 Md. 181, (cited above and also cited by Counsel under their "Point B") the Court holds that the rules of the Clearing House are binding only on its members and have no effect upon the rights and liabilities of other parties and that (page 184):

> "The failure of the appellant to offer to return the check and to demand repayment within the time prescribed by the rules of the Clearing House would therefore not impair its claim against the payee for the restoration of the fund if its right of recovery should be otherwise perfect."

In the case at bar the settlement remained conditional as to the endorsers who were members of the Clearing House until two thirty o'clock in the afternoon of the same day the checks were presented and notice not having been given by that time, they were discharged. It remained conditional until the expiration of the time prescribed by the Negotiable Instrument law as to non-members. Notice was given to Ashland Bank within that time.

Further, in 3 Ruling Case Law, Sec. 444, at page 1222, it is stated:

> "It is thoroughly settled that the holder of a promissory note, on which there are several indorsers is not bound to give notice to any except the one he intends

to hold liable, and that the indorser so notified has no right to complain of the holder, that his previous indorsers were not notified."

In 8 Corpus Juris, 643, Sec. 905, it is stated:

"The holder, however, may give notice to a remote indorser whom he intends to hold liable, without giving notice to or through intermediate parties, since he is not obliged to give notice to any party to whom he does not look for payment, notwithstanding the fact that by so doing he may discharge all intermediate parties for want of notice."

A large number of authorities are cited to sustain this principle. There seems to be none to the contrary. It would unduly lengthen this argument to cite them. As stated the rule is thoroughly settled and well known.

CONCLUSION.

It is, therefore, respectfully submitted that this Court should affirm the decision of the Circuit Court of Appeals for the Seventh Circuit.

DANIEL M. HEALY,
Counsel for Respondent, W. F. Leimert, Receiver of Central Manufacturing District Bank.